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In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 412

FRED W. WOODWARD AND ELSIE M. WOODWARD, F. R. WOODWARD AND M. JEANNE WOODWARD, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

No. 528

UNITED STATES OF AMERICA, PETITIONER

v.

HILTON HOTELS CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE COMMISSIONER AND THE UNITED STATES

OPINIONS BELOW

No. 412. The findings of fact and opinion of the Tax Court (R. 28–47)[1] are reported at 49 T.C. 377.

[1] "R." refers to the record appendix in No. 412, *Woodward* v. *Commissioner*.

The opinion of the court of appeals (R. 49–63) is reported at 410 F. 2d 313.

No. 528. The opinion of the district court (528–R. 33–36)[2] is reported at 285 F. Supp. 617. The opinion of the court of appeals (528–R. 37–41) is reported at 410 F. 2d 194.

JURISDICTION

No. 412. The judgment of the court of appeals was entered on May 2, 1969 (R. 64). The petition for a writ of certiorari was filed on July 31, 1969, and certiorari was granted on October 20, 1969 (R. 65). The jurisdiction of this Court rests on 28 U.S.C. 1254 (1).

No. 528. The judgment of the court of appeals was entered on April 15, 1969 (528–R. 42). By order dated June 30, 1969, Mr. Justice Stewart extended the time for filing a petition for a writ of certiorari to and including August 28, 1969. The petition was filed on that day, and certiorari was granted on December 8, 1969 (528–R. 43). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, for federal income tax purposes, expenditures incurred in connection with an appraisal proceeding to fix the value of dissenting shareholders' stock are deductible as ordinary and necessary expenses relating to property held for the production of income or as ordinary and necessary business expenses, or are nondeductible capital outlays.

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[2] "528–R." refers to the record appendix in No. 528, *United States* v. *Hilton Hotels Corporation.*

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 162, 212 and 263 of the Internal Revenue Code of 1954 and Sections 1.212–1(n) and 1.263(a)–2 of the Regulations thereunder are set forth in the Appendix, *infra*, pp. 28–31.

STATEMENT

Factually, these cases present several common features: (1) a course of action voted upon by a requisite number of a corporation's shareholders, to which certain shareholders dissented; (2) a requirement under state law that the dissenting shareholders' stock be purchased at its fair value; (3) an appraisal proceeding to fix the fair value of the dissenters' shares; and (4) the expenditure of legal and related fees by the purchaser of the dissenters' shares in connection with the appraisal proceeding. In No. 412, the Eighth Circuit has held that these expenditures are nondeductible capital outlays; while the Seventh Circuit in No. 528 has held them to be deductible.

No. 412. As of June 9, 1960, petitioners [3] owned directly 511 of the 1,200 outstanding shares of the common stock of the Telegraph-Herald, a corporation organized under the laws of the State of Iowa. Petitioners Elsie M. Woodward and M. Jeanne Woodward were trustees of two trusts which owned a total

[3] Petitioners Elsie M. Woodward and M. Jeanne Woodward are the wives of petitioners Fred W. Woodward and F. R. Woodward, respectively, and are parties to this action solely because they filed joint returns with their husbands (R. 29).

of 300 additional shares. Originally incorporated in 1901, the Telegraph-Herald was engaged in publishing a daily newspaper and operating a commercial printing plant and radio station. Its corporate existence was renewed in 1921 and 1941. Under the 1941 renewal, its life was extended for 20 years to November 1, 1961. (R. 29–30.)

On June 9, 1960, the common stockholders of the Telegraph-Herald held a special meeting for the purpose of further extending its corporate charter. A resolution was adopted by the holders of a majority of the stock under which the corporate life was extended in perpetuity. Thereafter, on or about June 10, 1960, the Secretary of State for the State of Iowa issued a certificate for the renewal of the Telegraph-Herald's corporate charter. (R. 30.)

Of the 1,200 outstanding shares of Telegraph-Herald common stock, 811 shares owned or controlled by petitioners and 10 shares owned by the Estate of Ellen Murphy were voted in favor of renewal of the corporate existence. The remaining 379 shares owned by Margaret M. Quigley were voted against renewal. Because Iowa law (Iowa Code Ann. (1969 Cum. Ann. Pocket Pt.) Sec. 491.25) required "those stockholders voting for such renewal * * * [to] purchase at its real value the stock voted against such renewal * * *," petitioners, as the majority stockholders, attempted to reach agreement with Margaret M. Quigley as to the "real value" of her stock. This effort was unsuccessful. Accordingly, on February 9, 1962, petitioners filed a petition in equity in the District Court of Iowa

(Dubuque County) requesting a determination of the real value of Margaret M. Quigley's stock.[4] A decision was entered by the district court on May 18, 1963, establishing a value of $1,750 per share. On appeal to the Supreme Court of Iowa (*Woodward* v. *Quigley,* 257 Iowa 1077, 133 N.W. 2d 38), that court determined the real value of Margaret M. Quigley's shares to be $1,650 per share. On rehearing (257 Iowa 1077, 136 N.W. 2d 280), the court fixed the real value at $1,620 per share. (R. 31–32.)

On July 16, 1965, following the entry of final judgment in *Woodward* v. *Quigley,* petitioners purchased Margaret M. Quigley's 374 shares of stock[5] as required by Iowa law (R. 32–33).

During 1963, petitioners paid attorneys', accountants' and appraisers' fees, costs and disbursments in the total amount of $25,733.74 for services rendered in connection with the determination of the real value of Mrs. Quigley's stock (R. 33–34).

Petitioners claimed deductions for this amount which the Commissioner disallowed "because the fees represent capital expenditures incurred in connection with the acquisition of capital stock of a corporation * * *" (R. 34). The Tax Court sustained the Commissioner's determination that the expenditures

[4] All of the majority shareholders, with the exception of the Estate of Ellen Murphy, participated in the state court proceedings (R. 32).

[5] Petitioners purchased the shares as follows: Fred W. Woodward—184 shares; F. R. Woodward—27 shares; M. Jeanne Woodward—25 shares; and the two trusts—138 shares. The remaining five shares were purchased by the Estate of Ellen Murphy. (R. 33.)

were not deductible on the ground that the "value-setting litigation and its attendant expenses were directly tied to the stock purchase and the expenses were part of the cost of the stock" (R. 36). On petitioners' appeal, the Eighth Circuit affirmed, holding (R. 63) that "the transaction involved the purchase of capital assets." In so concluding, the court of appeals rejected the contention that the appraisal proceeding was an event separate and distinct from the stock purchase and essentially disapproved the approach taken by the Seventh Circuit in No. 528. It observed (*ibid.*) that "The valuation of those assets [Mrs. Quigley's shares] was vital to the purchase, and the litigation necessary for valulation was thus inextricably woven into the fabric of the overall transaction."

This Court granted the taxpayers' petition for certiorari on October 20, 1969 (R. 65).

No. 528. In September 1953, Hilton Hotels Corporation ("Hilton") owned 325,370.5 of the 366,040.75 issued shares of Hotel Waldorf-Astoria Corporation ("Waldorf"). In August 1953, Hilton retained Standard Research Consultants, Inc., to prepare a merger study to determine the number of Hilton shares that would be a fair basis for an exchange for the 40,670.25 outstanding Waldorf shares not held by Hilton. The final report submitted by Standard Research in October 1953 concluded that Hilton would be justified in offering 1.25 shares of its common stock for each share of Waldorf stock as a fair basis of merger. (528–R. 5–6.)

On November 12, 1953, Hilton and Waldorf entered into an agreement of merger which provided that Hilton would be the surviving corporation and 1.25 shares of Hilton stock would be offered for each outstanding Waldorf share not held by Hilton. Subsequently, on December 28 and 29, 1953, the holders of more than two-thirds of the stock of Hilton and Waldorf voted to approve the merger. Prior to the vote, the holders of 20,221 Waldorf shares, pursuant to Section 91 of the New York Stock Corporation Law, filed with Waldorf their written objections to the merger and demanded payment for their stock. Thereafter, on December 31, 1953, the merger agreement and the certificate of consolidation were filed and recorded with the Secretary of State of New York, pursuant to Section 91 of the New York Stock Corporation Law. (528–R. 6–7.)

On January 7, 1954, Hilton offered to the dissenting holders of the 20,221 Waldorf shares a payment of $24.54 per share. The offer was rejected and the dissenting shareholders began proceedings, pursuant to Section 21 of the New York Stock Corporation Law, in the Supreme Court of New York (New York County) for a determination of the value of their Waldorf shares. (528–R. 7–8.)

During the period January through May, 1954, Hilton asked Standard Research to value the Waldorf common stock as of December 27, 1953, the day prior to the shareholders' vote approving the merger. This valuation study included the preparation of charts and tables supporting its opinion and the giving of

testimony in the appraisal proceeding. Hilton also obtained the services of lawyers, and other professional services, in connection with the appraisal proceeding. Ultimately, the appraisal proceeding was terminated by order of the New York County Supreme Court on June 14, 1955, upon its approval of the parties' settlement.[6] (528–R. 8–9.)

Hilton deducted $17,500 paid to Standard Research and $39,758.62 in other fees relating to the appraisal proceeding, which the Commissioner disallowed (528–R. 5, 10, 35). The sole issue litigated in the subsequent refund action in the district court was whether these amounts were nondeductible capital outlays, as the government contended, or were immediately deductible ordinary and necessary business expenses, as Hilton urged. Hilton conceded—and the district court held—that so much of the payment to Standard Research as pertained to the pre-merger determination of a fair basis of merger between Waldorf and Hilton could not be currently deducted. This holding was based on the established rule that expenses incurred in connection with a corporate reorganization are nondeductible capital outlays. (528–R. 33.) The district court concluded, however, that the fees and costs relating to the appraisal proceeding were currently deductible (528–R. 36). On appeal, the Seventh Circuit

[6] The settlement provided for payment of five-eighths of a share of Hilton stock for each share of Waldorf stock, but without any fractional shares issued. In addition, Hilton was to pay $6 for each one-eighth share of Hilton common stock which would have otherwise been required to be issued as a fractional share. (528–R. 9.)

affirmed (528–R. 37–41), holding that since, under New York law, the merger became effective and title to the dissenters' shares passed to Hilton in advance of the appraisal proceeding, "the expenses experienced by Hilton in connection with such proceedings were not capital in nature and were therefore deductible as ordinary and necessary business expenses" (528–R. 40).

The government's petition for certiorari was granted on December 8, 1969 (528–R. 43).

ARGUMENT

INTRODUCTION AND SUMMARY

The federal income tax law has long made the distinction between expenses that are currently deductible against income and expenditures which must be capitalized. So far as relevant here, Section 162(a) of the Internal Revenue Code of 1954, under which Hilton claimed deduction for its appraisal expenses, provides that a deduction shall be allowed for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Section 212, which is the basis for Woodward's claim, provides that, "In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year * * * (2) for the management, conservation, or maintenance of property held for the production of income * * *."

The effect of these two provisions is to allow the deduction of only such expenses as relate to profit-seek-

ing activities—whether or not in a trade or business—rather than personal activities. However, the goal of profit-making is not enough to render the expense deductible. Section 263 must also be surmounted. It forbids a current deduction under language—captioned "Capital expenditures"—which has been unchanged since 1913[7]: "[a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." If an expenditure falls within the scope of this statutory description, it is taken into account as a part of the cost of the property, and, unless the property is subject to depreciation or amortization, its cost is recoverable only when the property ultimately is sold or disposed of in a taxable transaction.

Capital expenditures are usually defined as those outlays made to acquire a tangible or intangible asset or benefit with a useful life of more than one year. See, *e.g.*, *Wells-Lee* v. *Commissioner*, 360 F. 2d 665 (C.A. 8); *Teitelbaum* v. *Commissioner*, 294 F. 2d 541 (C.A. 7), certiorari denied, 368 U.S. 987; *United States* v. *Akin*, 248 F. 2d 742 (C.A. 10), certiorari denied, 355 U.S. 956. Since the costs incurred in connection with the acquisition of a capital asset, *e.g.*, legal, accounting, brokerage and other similar expenses, are part of the cost of acquiring the asset, such outlays constitute capital expenditures, to be added to the cost basis of the asset for purposes of computing gain or loss on disposition. See, *e.g.*, *Helvering* v. *Win-*

[7] See Section II (B) of the Income Tax Act of 1913, c. 16, 38 Stat. 114, 167.

mill, 305 U.S. 79; *Godfrey* v. *Commissioner,* 335 F. 2d 82 (C.A. 6), certiorari denied, 379 U.S. 966; *Spangler* v. *Commissioner,* 323 F. 2d 913 (C.A. 9); *United States* v. *St. Joe Paper Co.,* 284 F. 2d 430 (C.A. 5); *Atzingen-Whitehouse Dairy, Inc.* v. *Commissioner,* 36 T.C. 173.

Costs incurred in connection with a corporate reorganization also are subject to capital treatment. As in the case of costs incurred in the acquisition of capital assets, reorganization expenses are capitalized because they are part of the cost of the reorganization and, as such, provide a benefit extending beyond the year in which they are incurred. See, *e.g., General Bancshares Corp.* v. *Commissioner,* 326 F. 2d 712, 715 (C.A. 8), certiorari denied, 379 U.S. 832; *Missouri-Kansas Pipe Line Co.* v. *Commissioner,* 148 F. 2d 460, 462 (C.A. 3); *Skenandoa Rayon Corp.* v. *Commissioner,* 122 F. 2d 268, 271 (C.A. 2), certiorari denied, 314 U.S. 696; *Motion Picture Capital Corp.* v. *Commissioner,* 80 F. 2d 872 (C.A. 2); *Odorono Co.* v. *Commissioner,* 26 B.T.A. 1355.

There is no dispute between the parties regarding the existence of these basic rules of federal income taxation. The sole question is whether these rules apply to the appraisal expenses incurred by Woodward and Hilton. The principal contention of both Hilton and Woodward as the cases reach this Court is that these rules do not apply because, under state law, title to the dissenters' shares passed to the purchasers in advance of the appraisal proceedings. Our position is that it makes no difference for federal in-

come tax purposes whether the passage of title precedes or follows the appraisal proceeding under local law. Regardless of the timing sequence of these events, the appraisal expenses are a part of the cost of acquisition of the dissenters' shares and, as such, must be capitalized.

I. THE APPRAISAL EXPENSES IN QUESTION ARE CAPITAL EXPENDITURES

Two decisions of this Court show the way to the conclusion that the appraisal expenses incurred by Woodward and Hilton are nondeductible capital outlays. These are *Helvering* v. *Winmill,* 305 U.S. 79, and *United States* v. *Gilmore,* 372 U.S. 39.

In *Winmill,* this Court approved longstanding Treasury Regulations to the effect that brokerage commissions paid in connection with the purchase of securities are not deductible, but must be added to the cost basis of the securities.[8] See Treasury Regulations (1954 Code), Section 1.263(a)–2(e), Appendix, *infra,* p. 30. It held unanimously (305 U.S. at 84) that the commissions "constituted a part of the acquisition cost of the securities" even if paid by a person in the trade or business of buying and selling securities.

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[8] Other applications of the *Winmill* rationale, that expenses incurred in connection with the acquisition of an asset are to be capitalized, are *Iowa Southern Utilities Co.* v. *Commissioner,* 333 F. 2d 382 (C.A. 8) (litigation fees in connection with shareholders' derivative suit); *Spangler* v. *Commissioner,* 323 F. 2d 913 (C.A. 9) (litigation fees incurred by minority shareholders to recover damages from corporation for fraudulent inducement of sale of their stock); *Brown* v. *Commissioner,* 215 F. 2d 697 (C.A. 5) (litigation expenses relating to will contest); *Garrett* v. *Crenshaw,* 196 F. 2d 185 (C.A. 4) (legal fees paid in suit to establish trust over property); *Addison* v. *Commis-*

For purposes of characterization as expense or capital items, the appraisal expenses incurred by Woodward and Hilton cannot be distinguished from the commissions involved in *Winmill*. Both types of expenses were incurred as a part of the process of acquisition of shares of stock. The various appraisal costs of Woodward and Hilton were expended in determining the acquisition price of the capital assets themselves; the brokerage fees in *Winmill* were a function of an agreed acquisition price.

Hilton attempts to avoid the brokerage fee analogy, without citation of *Winmill*, on the ground that (Br. in Opp. 8, n. 23) "expenses incurred for the valuation of acquired stock differ substantially from brokerage fees arising as *part* of a transaction of acquiring or selling stock." But this Court did not hold that the brokerage fees in *Winmill* were to be capitalized because they arose "as *part* of a transaction of acquiring or selling stock." It held (305 U.S. at 84) that the fees were to be capitalized because they "constituted a part

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sioner, 177 F. 2d 521 (C.A. 8) (legal fees paid in action to have sale of securities set aside); *Bowers* v. *Lumpkin*, 140 F. 2d 927 (C.A. 4), certiorari denied, 322 U.S. 755 (litigation expenses in connection with defense of action to set aside taxpayer's purchase of stock).

Similarly, the corollary of *Winmill*, that expenses incurred in connection with the sale of an asset are not currently deductible but must be offset against the proceeds of sale, is well established. *Spreckels* v. *Commissioner*, 315 U.S. 626; *Godfrey* v. *Commissioner*, 335 F. 2d 82 (C.A. 6), certiorari denied, 379 U.S. 966; *Munson* v. *McGinnes*, 283 F. 2d 333 (C.A. 3), certiorari denied, 364 U.S. 880; *Ward* v. *Commissioner*, 224 F. 2d 547 (C.A. 9); *Isaac G. Johnson & Co.* v. *United States*, 149 F. 2d 851 (C.A. 2); *Towanda Textiles, Inc.* v. *United States*, 180 F. Supp. 373 (Ct. Cl.).

of the acquisition cost of the securities." The Court did not adopt a transactional approach, as Hilton would have it. The Court's decision was that brokerage fees must be capitalized—and this did not depend on whether the fees were reckoned in separate transactions before or after the acquisition of the securities or simultaneously with the acquisition.

In *United States* v. *Gilmore,* 372 U.S. 39, this Court ruled that expenses incurred by the taxpayer in defending against his former wife's claim for alimony, and a community property settlement incident to divorce, were personal and, therefore, nondeductible expenses, even though the taxpayer would have suffered business injury if the wife's claim had been successful. In reaching this conclusion, the Court held (372 U.S. at 49) that the characterization of a litigation expenditure was dependent upon two criteria—the "origin and character of the claim with respect to which an expense was incurred." Since the "origin" of the ex-wife's claim, with respect to which the litigation expenses were incurred, lay in the marital relationship, and since the "character" of that claim was personal, the litigation expenses were not deductible.

Although *Gilmore* involved the question whether litigation expenses were business or personal expenses, its rationale applies with equal force in determining whether litigation expenses incurred in a profit-seeking context are subject to expense or capital treatment. Here the "origin" of Mrs. Quigley's claim to

payment for her shares, and the claim of the dissenting Waldorf shareholders, with respect to which the appraisal expenses were incurred, was the acquisition of their stock by Woodward and Hilton. The "character" of the claims—the amounts to be paid for capital assets—indisputably was capital in nature. Under the teaching of *Gilmore,* therefore, the appraisal costs may not be deducted.

Ignoring the decisions of this Court in *Helvering* v. *Winmill* and *United States* v. *Gilmore, supra,* the Seventh Circuit relied upon *Smith Hotel Enterprises, Inc.* v. *Nelson,* 236 F. Supp. 303 (E.D. Wis.), which held that a corporate taxpayer's litigation expenses paid in connection with an appraisal proceeding to fix the value of a dissenter's shares were deductible under Section 162.[9] In so holding, the district court followed *Heller* v. *Commissioner,* 147 F. 2d 376 (C.A. 9), affirming 2 T.C. 371, certiorari denied, 325 U.S. 868, cited by both Woodward (Br. 12, 40–43) and Hilton (Br. in Opp. 6, n. 13), where the Ninth Circuit held, prior to this Court's decision in *Gilmore,* that appraisal costs incurred by a dissenting shareholder were deductible under Section 212.[10] But the

[9] Squarely in conflict with *Smith Hotel* and the decision in *Hilton* is *Boulder Building Corp.* v. *United States,* 125 F. Supp. 512 (W.D. Okla.). The Eighth Circuit noted this conflict (R. 62) and endorsed *Boulder Building* as "[t]he better view."

[10] The district court in *Smith Hotel* also relied on the fact that the taxpayer's obligation to purchase the dissenter's shares was an "involuntary obligation." 236 F. Supp. at 305. Woodward similarly argues (Br. 21) that the appraisal expenses should not be capitalized because the majority shareholders were obligated to purchase Mrs. Quigley's stock under Iowa law

Ninth Circuit disapproved its *Heller* opinion in *Spangler* v. *Commissioner*, 323 F. 2d 913, 919–920, n. 15, where the taxpayer sought to deduct under Section 212 the litigation expenses of a suit in which he recovered, *inter alia*, the value of stock on a corporate liquidation. The court ruled that the litigation expenditure was a nondeductible capital outlay on the theory that costs connected with the acquisition of a capital asset, like "[c]osts connected with the disposition of a capital asset are also capital expenditures * * * rather than expenses deductible from ordinary income." 323 F. 2d at 921. See also *Ward* v. *Commissioner*, 224 F. 2d 547, 553–554 (C.A. 9). *Spangler*, and not *Heller*, represents the governing rule in the Ninth Circuit.[11]

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and did not do so voluntarily. The decisions to merge (in *Hilton*) and to extend the charter (in *Woodward*), however, were wholly voluntary. Moreover, the fact that an acquisition is involuntary is immaterial. As the Third Circuit stated in *Woolrich Woolen Mills* v. *United States*, 289 F. 2d 444, 448, "The involuntary nature of the expenditure * * * does not render deductible as expense an item which would otherwise be nondeductible as capital." See also *Teitelbaum* v. *Commissioner*, 294 F. 2d 541, 544 (C.A. 7), certiorari denied, 368 U.S. 987, and cases cited therein; *Russell Box Co.* v. *Commissioner*, 208 F. 2d 452, 454–455 (C.A. 1); *RKO Theatres, Inc.* v. *United States*, 163 F. Supp. 598 (Ct. Cl.).

[11] The correctness of *Naylor* v. *Commissioner*, 203 F. 2d 346 (C.A. 5), relied upon by Woodward (Br. 45, 47) and Hilton (Br. in Opp. 5, 9, 10) also has been questioned by the Ninth Circuit in *Spangler* (323 F. 2d, pp. 919–920, n. 15) and in 4A Mertens, Law of Federal Income Taxation (1966 rev. ed.), Section 25A.12, n. 40. *Naylor* is to be compared with the later decision of the Fifth Circuit in *United States* v. *St. Joe Paper Co.*, 284 F. 2d 430, which we believe represents the law of that circuit.

Like the district court in *Smith Hotel, supra,* the Seventh Circuit held that the "primary purpose" test enunciated in *Rassenfoss* v. *Commissioner,* 158 F. 2d 764 (C.A. 7), was applicable. The "primary purpose" test developed as an adjunct to the general rule that the cost of defending or perfecting title to property is a nondeductible capital expenditure. Treasury Regulations on Income Tax (1954 Code), Section 1.263 (a)–2(c), Appendix, *infra,* p. 30. Under this test, if litigation arises in a business or profit-seeking context, the attendant costs do not have to be capitalized merely because the end result of such litigation is the transfer of title to property; current deductibility is justified on the ground that the "primary purpose" of the litigation was something other than the defense or perfection of title. See, *e.g., Industrial Aggregate Co.* v. *United States,* 284 F. 2d 639, 645 (C.A. 8); *Manufacturers Hanover Trust Co.* v. *United States,* 312 F. 2d 785, 789–791 (Ct. Cl.).

It is apparent that the "primary purpose" test involving, as it must, a weighing of the title aspects of litigation against the other aspects of litigation, can have no bearing in these cases. The appraisal proceedings involved here were premised upon the obligation of both Woodward and Hilton to purchase the dissenters' shares. In these circumstances, neither the rule concerning defense or perfection of title, nor the adjunct "primary purpose" test is relevant.[12]

[12] Nothing in *Usry* v. *Price,* 325 F. 2d 657 (C.A. 5); *Vincent* v. *Commissioner,* 219 F. 2d 228 (C.A. 9); or *Gravois Planing Mill Co.* v. *Commissioner,* 299 F. 2d 199 (C.A. 8), relied upon

II. THE PRINCIPLE THAT EXPENSES INCURRED IN CONNECTION WITH THE ACQUISITION OF CAPITAL ASSETS MUST BE CAPITALIZED IS APPLICABLE TO BOTH CASES

Hilton's principal argument in its brief in opposition (pp. 11–14) is that its case is distinguishable from *Woodward* because, under New York law, the merger of Waldorf into Hilton became effective, and title to the dissenters' shares passed to Hilton, in advance of the appraisal proceeding. Hilton attempts to justify the Seventh Circuit's decision on the ground that it was based on the peculiarities of New York law (*id.* p. 11), and seems to agree that *Woodward* was correctly decided under Iowa law (*id.* p. 7). Woodward insists, despite the contrary finding of the Eighth Circuit (R. 55), that the Iowa law applicable to its appraisal proceeding is exactly like the New York law involved in Hilton. In short, Hilton asserts that

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by Hilton (Br. in Opp. 4, 5, 6), lends support to its position. In *Price*, the Fifth Circuit held that litigation expenses incurred to defend a quiet title action were currently deductible because of the peculiar circumstance there that the taxpayer's title had already been established by prior litigation which was res judicata. Compare, however, *Galewitz* v. *Commissioner*, 411 F. 2d 1374 (C.A. 2), certiorari denied, November 10, 1969 No. 485, O.T., 1969 (38 U.S. Law Week 3173). The Ninth Circuit's *Vincent* decision was premised on a theft loss theory (219 F. 2d at 231) which is irrelevant here; moreover, *Vincent* was criticized by the Ninth Circuit in *Spangler* v. *Commissioner*, *supra*, at 919–920, n. 15. *Gravois Planing Mill Co.*, holding that expenditures in connection with a partial liquidation may be deducted, presents a wholly different question and is to be contrasted with the subsequent decisions of the Eighth and Seventh Circuits in *United States* v. *Morton*, 387 F. 2d 441, 448–450 (C.A. 8), and *Alphaco, Inc.* v. *Nelson*, 385 F. 2d 244, 245 (C.A. 7).

the Eighth Circuit's decision in No. 412 is distinguishable, while Woodward argues it is wrong and seeks (Br. 22–26, 35–38) to bring its case within the ambit of the Seventh Circuit's title analysis.

We agree with Hilton that the Iowa law [13] construed by the Eighth Circuit is different, in terms of the timing of title passage from the New York law [14] interpreted by the Seventh Circuit. We disagree with Hilton, however, that the federal income tax treatment of appraisal expenses should turn on that difference. The other differences between the *Hilton* and *Woodward* cases, enumerated but not explicated in Hilton's brief in opposition (pp. 7–8), similarly do not warrant a difference in result.

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[13] The Iowa law (Iowa Code Ann. §491.25) provides that majority shareholders voting for renewal "shall have three years from the date such action for renewal was taken in which to purchase and pay for the stock voting against such renewal * * *." Under this language, the actual purchase of a dissenter's stock, with the attendant transfer of title, does not occur until after the purchase price has been fixed either through agreement or in an appraisal proceeding. While the obligation of the majority shareholders to purchase dissenters' shares arises on the date of the corporate renewal, as Woodward contends (Br. 35–36), neither the Iowa statute, nor any of the cases cited by Woodward, establish that dissenters lose any of their rights as stockholders, or that title passes to the majority shareholders, prior to the actual purchase of the dissenters' shares.

[14] Section 91(9) of the New York Stock Corporation Law provides that a corporate consolidation becomes effective upon the filing of the requisite certificate. Section 21(6) of the same law provides that as of the time of a merger vote, a dissenting shareholder loses all rights as such, except the right to receive payment for the value of his shares.

A. THE DIFFERENCE IN THE TIMING OF TITLE PASSAGE UNDER NEW YORK AND IOWA LAW IS NOT RELEVANT FOR FEDERAL INCOME TAX PURPOSES

The basic thrust of Hilton's argument is that the appraisal expenses it incurred were not part of the cost of acquisition of the shares of the dissenting Waldorf stockholders because, under New York law, Hilton had already acquired the shares. Woodward's appraisal expenses, on the other hand, were part of the cost of Mrs. Quigley's stock, in Hilton's view, because Woodward did not acquire that stock until after the price had been fixed in the appraisal proceeding.

This difference in the timing of title passage under New York and Iowa law cannot mask the fact that in *Hilton,* as well as in *Woodward,* the appraisal proceeding was directly related to the acquisition of dissenters' shares and, indeed, had no independent purpose of its own. Once the requisite shareholder vote had been taken in each case, the obligation to purchase the dissenters' shares was fixed. All that remained to be determined was the price to be paid for the shares. The fact that the appraisal proceeding occurred after the merger was effected in *Hilton* is of no moment, for the tax law often links together events that are temporally separated so long as they are functionally related. See *e.g., American Bantam Car Co.* v. *Commissioner,* 11 T.C. 397, 405, affirmed *per curiam,* 177 F. 2d 513 (C.A. 3), certiorari denied, 339 U.S. 920; *Kimbell-Diamond Milling Co.* v. *Commissioner,* 14 T.C. 74, affirmed *per curiam,* 187 F. 2d 718 (C.A. 5), certiorari denied, 342 U.S. 827. See also

Arrowsmith v. *Commissioner*, 344 U.S. 6; *United States* v. *Skelly Oil Co.*, 394 U.S. 678, 684–685.

Contrary to Hilton's assertion (Br. in Opp. 9), we do not contend that an expense must be capitalized merely because it "is incidental to, grows out of, or can be foreseen as a result of another [capital] transaction." The appraisal expenses incurred by Hilton were not merely incidental or forseeable expenses of Hilton's acquisition of dissenters' shares; they were inherent in the acquisition itself, since they were incurred in connection with an obligation to pay the dissenting Waldorf shareholders for the shares, which was an inseparable component of the acquisition.[15] The appraisal proceeding in *Hilton*, no less than in *Woodward*, was "inextricably woven into the fabric of the overall transaction" (R. 63).[16]

[15] To say, as the Seventh Circuit did (528–R. 40), that the "sole purpose" of the Hilton appraisal proceeding was to value the shares of the dissenting Waldorf stockholders, does not help Hilton's case. Rather, it reinforces the conclusion that the appraisal proceeding was an inherent part of the acquisition process.

[16] Hilton's theory that because of the provisions of New York law, the stock acquisition and the appraisal proceeding must be considered two independent events for tax purposes, leads ultimately to the conclusion that the price paid for the stock, as well as the appraisal expenses, may be deducted. For if the acquisition was an entirely separate event, Hilton paid nothing for the stock and its subsequent payment, occurring as it did after the passage of title and the effective date of the merger, was merely an incidental or foreseeable cost of the acquisition. Such a result, of course, is inconsistent with Section 263 and well-settled case law concerning capital expenditures, and Hilton has made no claim that the price paid for the stock itself is deductible.

Given the functional relationship between the stock acquisition and the appraisal proceeding in each of the instant cases, the tax treatment of the appraisal expenses in question cannot be controlled by the passage-of-title provisions of New York or Iowa law, which are based on policy considerations wholly different from those underlying Sections 162, 212 and 263. Numerous decisions of this Court make it clear that the refinements of title under state law do not govern federal tax consequences unless the revenue statutes explicitly or implicitly so provide. *Burnet* v. *Harmel,* 287 U.S. 103, 110–111; *Corliss* v. *Bowers,* 281 U.S. 376, 378; *Griffiths* v. *Commissioner,* 308 U.S. 355, 357; *Helvering* v. *Clifford,* 309 U.S. 331, 334; *Estate of Putnam* v. *Commissioner,* 324 U.S. 393, 395–396. Cf. *Biddle* v. *Commissioner,* 302 U.S. 573, 578–579. See also *Lyeth* v. *Hoey,* 305 U.S. 188, 194; *Morgan* v. *Commissioner,* 309 U.S. 78, 80; *Commissioner* v. *Sullivan,* 356 U.S. 27, 28–29.

In *Burnet* v. *Harmel, supra,* the taxpayer, who owned certain Texas oil lands in fee, executed oil and gas leases in exchange for cash payments and royalties and claimed capital gains treatment on the cash proceeds, relying upon the Texas law which provided that title to the oil and gas in place passed to the lessee immediately upon the execution of the leases. In rejecting this argument, this Court stated (287 U.S. at 110–111):

> * * * [W]e find in the Texas leases no differences from those leases where the title to the oil and gas passes only on severance by the lessee,

> which are of sufficient consequence to call for any different application of § 208. *The fact that title to the oil and gas is said to pass before severance, rather than after, is not such a difference.* * * * [Emphasis supplied.]

Similarly, the fact that title to the dissenters' shares here may have passed before, rather than after, the appraisal proceeding "is not such a difference" as to warrant a difference in the tax treatment of the appraisal expenses. As the Ninth Circuit observed in *Spangler* v. *Commissioner,* 323 F. 2d 913, 920, in holding that litigation expenses incurred in connection with the acquisition of stock must be capitalized, the refinements of title under state law are "irrelevant to the proper tax treatment of the costs of litigation." [17]

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[17] Hilton suggests (Br. in Opp. 12) that the law of New York is unique: "No other state's statutes cause a dissenting stockholder *prior* to the date the merger is effected to lose all his proprietary stock rights and be granted only the right to receive the value of the stock." On this basis it contends (*id.*, pp. 11–14) that a decision favorable to it would not apply under the laws of any other state. Even assuming that the federal tax treatment of appraisal expenses depends on state law, this is incorrect. As we noted in our petition (pp. 14–16), in every jurisdiction with the exception of West Virginia, a merger becomes effective, even if there are dissenting shareholders, upon the filing of an appropriate certificate in accordance with state law. Thus, outside of West Virginia, it can be argued under Hilton's theory that the appraisal proceeding is entirely separate from the merger. Hilton points out (Br. Opp. 13), however, that in its case both "[t]he loss of [dissenting shareholder] rights and the merger occurred long before the valuation proceedings." This is not unique under New York law. In 22 other jurisdictions, both events occur in advance of the appraisal proceeding (see Br. in Opp. 12–13, n. 39, points

B. THERE ARE NO OTHER DISTINCTIONS BETWEEN THE INSTANT CASES THAT WARRANT A DIFFERENCE IN THE FEDERAL INCOME TAX TREATMENT OF THE APPRAISAL EXPENSES IN QUESTION

Hilton points to a variety of other distinctions between its case and Woodward's (Br. in Opp. 6–8). Many of these simply are restatements of Hilton's principal argument on the timing of title passage, and we do not discuss them here. There seem to be three additional arguments that do not turn on the title passage aspect. These are the following: (1) that Hilton claimed its deduction under Section 162 of the Code, while Woodward's claim rests on Section 212; (2) that Hilton involves dissenters' rights arising out of a merger, while the dissenter's rights in *Woodward* arose because of the renewal of a corporate charter; and (3) that in *Hilton* the corporation acquired the dissenters' shares, while in *Woodward* the purchase was made by the majority shareholders.

None of these factual differences is significant. Hilton conceded as much in the district court when it abandoned its claim (R. 528–33) for deductibility of the expenses it incurred prior to the merger in the determination of a fair basis for the merger. If the distinctions had any merit either individually or collectively, they would have justified the deduction of the pre-merger expenses. The fact that they did not is best evidenced by Hilton's concession and the district

b, c, d and e), and in all of them it can be argued under Hilton's theory that the appraisal proceeding is a separate event for tax purposes.

court's holding (528–R. 33). They similarly do not justify the deduction of Hilton's appraisal expenses here in issue.

(1) *United States* v. *Gilmore,* 372 U.S. 39, 44–47, makes clear that the requirement that costs incurred in connection with the acquisition of a capital asset be capitalized applies equally to business expenditures otherwise deductible under Section 162 and to non-business expenditures otherwise deductible under Section 212. As the Eighth Circuit below recognized (R. 56–57), both Sections 162 and 212 are subject to the restriction of Section 263 against the deduction of capital expenditures.

Until 1942, "ordinary and necessary" expenses were deductible only if incurred in a "trade or business." See Section 23(a)(1) of the 1939 Code, which is the predecessor of Section 162(a). When Congress added the predecessor of Section 212 in the Revenue Act of 1942 (Section 23(a)(2) of the 1939 Code), it removed the bar that had previously existed to deductions incurred in profit-seeking activities that did not constitute a "trade or business." *Trust of Bingham* v. *Commissioner,* 325 U.S. 365; *Lykes* v. *United States,* 343 U.S. 118; Treasury Regulations (1954 Code), Section, 1.212–1(n), Appendix, *infra,* pp. 29–30; H. Rep. No. 2333, 77th Cong., 2d Sess., p. 75; S. Rep. No. 1631, 77th Cong., 2d Sess., p. 88. There is no support for Hilton's suggestion that an expenditure which would be considered capital if incurred in a Section 212 situation might somehow be a deductible expense if incurred in a trade or business.

(2) It is not entirely clear what significance Hilton

attempts to attribute to the fact that the dissenters' rights in *Woodward* arose out of the renewal of a corporate charter rather than a merger. Hilton's contention presumably is that, unlike *Woodward,* its case involves a reorganization and not a stock acquisition. Such an argument hardly comports with the facts, for in order to accomplish the merger, Hilton had to acquire all of the Waldorf shares not held by it. The obligation to exchange something of value for those Waldorf shares (Hilton stock for the assenting shareholders and cash for the dissenters) was an inherent part of the merger.

Moreover, as we have previously noted (p. 11, *supra*), the rule that expenses incurred in connection with a reorganization—here a merger described in Section 368(a)(1)(A) of the Code—must be capitalized is as firmly established as the parallel rule applicable to expenses incurred in connection with a stock acquisition. Indeed, the former rule was approved by Congress in 1954 when it enacted Section 248 of the 1954 Code, which permits amortization of certain organizational expenses of a corporation. Both the House and Senate Committee Reports on Section 248 state that "[e]xpenditures connected with the reorganization of a corporation are not incident to the creation of a corporation, and hence are not subject to the provisions of section 248." H. Rep. No. 1337, 83d Cong., 2d Sess., p. A64; S. Rep. No. 1622, 83d Cong., 2d Sess., p. 224. Thus, Hilton's expenses are to be treated like Woodward's, whether they are deemed to have arisen in connection with a stock acquisition or a reorganization.

(3) It can make no difference under Section 263 that a corporation acquired the dissenters' shares in *Hilton* and majority shareholders purchased the shares in *Woodward*. The determination whether an expenditure is a capital expenditure within the meaning of that provision depends only on the character of the expenditure.

In sum, *Hilton* and *Woodward* are, in all relevant respects indistinguishable. Neither the difference in the timing of title passage under New York and Iowa law, nor any other distinction suggested by Hilton, would support or justify different results in these cases. The proper result in each case is the capitalization of the appraisal expenses in question.

CONCLUSION

The decision of the Eighth Circuit in No. 412 should be affirmed; the decision of the Seventh Circuit in No. 528 should be reversed and the cause remanded to the district court with directions to dismiss the complaint.

Respectfully submitted.

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APPENDIX

Internal Revenue Code of 1954:

SEC. 162 [as amended by Sec. 4(b), Revenue Act of 1962, P.L. 87-834, 76 Stat. 976].

TRADE OR BUSINESS EXPENSES.

(a) *In General.*—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

[26 U.S.C. 162.]

SEC. 212. EXPENSES FOR PRODUCTION OF INCOME.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax.

[26 U.S.C. 212.]

SEC. 263. CAPITAL EXPENDITURES.

(a) *General Rule.*—No deduction shall be allowed for—

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to—

(A) expenditures for the development of mines or deposits deductible under section 616,

(B) research and experimental expenditures deductible under section 174,

(C) soil and water conservation expenditures deductible under section 175,

(D) [as added by Sec. 4, Act of September 14, 1960, P.L. 86–779, 74 Stat. 1001] expenditures by farmers for fertilizer, etc., deductible under section 180, or

(E) [as added by Sec. 21, Revenue Act of 1962, P.L. 87–834, 76 Stat. 1064] expenditures by farmers for clearing land deductible under section 182.

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

* * * * *

[26 U.S.C. 263.]

Treasury Regulations on Income Tax (1954 Code):

SEC. 1.212–1 *Nontrade or nonbusiness expenses.*

* * * * *

(n) Capital expenditures are not allowable as nontrade or nonbusiness expenses. The deduction of an item otherwise allowable under

section 212 will not be disallowed simply because the taxpayer was entitled under subtitle A of the Code to treat such item as a capital expenditure, rather than to deduct it as an expense. For example, see section 266. Where, however, the item may properly be treated only as a capital expenditure or where it was properly so treated under an option granted in subtitle A of the Code, no deduction is allowable under section 212; and this is true regardless of whether any basis adjustment is allowed under any other provision of the Code.

* * * * * *

[26 C.F.R. 1.212-1.]

Sec. 1.263(a)-2. *Examples of capital expenditures.*

The following paragraphs of this section include examples of capital expenditures:

(a) The cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

(b) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments.

(c) The cost of defending or perfecting title to property.

(d) The amount expended for architect's services.

(e) Commissions paid in purchasing securities. Commissions paid in selling securities are an offset against the selling price, except that in the case of dealers in securities such commissions may be treated as an ordinary and necessary business expense.

(f) Amounts assessed and paid under an agreement between bondholders or shareholders of a corporation to be used in a reorganization of the corporation or voluntary contributions by shareholders to the capital of the corporation

for any corporate purpose. Such amounts are capital investments and are not deductible. See section 118 and § 1.118–1.

(g) A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stockholdings in the subsidiary shall not deduct amounts paid in carrying out this guaranty in computing its taxable income, but such payments are capital expenditures to be added to the cost of its stock in the subsidiary.

(h) The cost of good will in connection with the acquisition of the assets of a going concern is a capital expenditure.

[26 C.F.R. 1.263(a)–2.]

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